

1. Introduction

This paper presents USAID/E&E's system for monitoring country progress in the twenty-seven transition country region. It is the seventh update of the original January 1997 report. As in past editions, transition progress is tracked along four primary dimensions: (1) economic reforms; (2) democratization; (3) macroeconomic performance; and (4) social conditions. An important objective of this report is to provide criteria for graduation of transition countries from USAID assistance, and, more generally, to provide guidelines in optimizing the allocation of USAID resources in the region.¹

2. Economic reforms

Eleven economic reform indicators are drawn from the EBRD and grouped into two stages of reform.² The first stage reforms consist of liberalization of prices, external trade and foreign currency reforms, privatization of small-scale units, and the establishment of key commercial laws (*Table 1*). The second stage reforms consist of large-scale privatization, enterprise restructuring (credit and subsidy policy), competition policy, financial sector reforms (including banking and capital markets), reforms in infrastructure, and the effectiveness of key commercial laws (*Table 2*). In general, whereas much of the first stage reforms focus on liberalizing the economy from government intervention or ownership, second stage reforms concentrate in large part on building the government's capacity to govern; that is, reconstructing a leaner and more efficient government capable of enforcing the rules and providing the public goods needed for a vibrant market economy to work.

Tables 1 and *2* provide a snapshot of progress in these economic reforms areas as of September 2001. Several highlights are worth noting. First, progress in first stage economic reforms remain considerably further advanced than progress in second stage reforms. In fact, most of the CEE countries have largely completed the first stage reforms; Bosnia-Herzegovina and Yugoslavia are the salient exceptions. In contrast, even the Northern Tier CEE reform leaders continue to lag considerably behind the EU in progress in second stage reforms. Overall, the greatest economic reform gains are found in first stage reforms of small-scale privatization, and trade and foreign exchange liberalization, while the fewest gains remain in the second stage reforms of enterprise restructuring, competition policy, and financial reforms, particularly non-bank financial reforms.

Second, the economic reform leaders are all Northern Tier CEE countries. Hungary, Estonia, and Poland are out front, followed closely by the five other Northern Tier CEE countries. Economic reform progress in the Southern Tier CEE and Eurasian countries

¹ Earlier editions provide elaboration of the application of graduation criteria as well theoretical justification of the indicators tracked in this report. See, e.g., *Monitoring Country Progress* No. 7 (October 2001). See also: USAID/E&E/PCS, *Considerations Regarding Exit Strategies for the Countries of the Southern Tier* (January 2002).

² The appendix provides elaboration of the economic reform indicators.

lags considerably overall, though variation in progress in these two regions is also much greater than it is in the Northern Tier CEE countries. Economic reform progress in the Southern Tier CEE countries ranges from that of Croatia and Bulgaria, where progress approaches Northern Tier CEE standards, to Bosnia-Herzegovina and Yugoslavia, where progress is closer to some of the Eurasian laggards, Tajikistan most notably. Kazakhstan, Moldova, and Georgia lead the Eurasian countries in economic reforms, with progress comparable to that found in Macedonia. Turkmenistan lags considerably behind all the transition countries in economic reform progress. It has not even started the reform process in seven of the eleven economic reform areas. The economic reform gap between Belarus and the rest is also large.

Third, notable economic reform progress was made in 2001. All but perhaps five countries made measurable net gains in economic reforms from September 2000 to September 2001; eleven countries made gains in both first and second stage reforms. This impressive progress is largely a continuation of significant gains during 2000; both years' progress represent notably better progress than gains in recent years past. Three of the five countries which did not show measurable net gains in 2001 are Northern Tier CEE leaders (Hungary, Poland, and the Czech Republic), where first stage reforms are largely complete and where the second stage reforms to be completed are much more difficult; hence, slow progress is expected. The other two (of five) countries where economic reform progress did not register in 2001 are in Eurasia: Kyrgyzstan and Turkmenistan.

Economic reform trends since mid-2001.³ Economic reform progress since mid 2001 has not been as robust as it was in the two preceding years. Roughly two-thirds of the transition countries measurably advanced in economic reforms on an annual basis from September 1999 through September 2001; since then, about one-half have made notable gains. A significant part of this slowdown is due to the deterioration in the global economy. For example, a number of key strategic privatizations have been delayed and/or put on hold due to an absence of interested international investors. However, some of this slower reform progress is also attributed to domestic factors, including diminished government commitment and transparency.

Economic reform backsliding since mid-2001 has occurred among countries at both ends of the reform spectrum. At one end is Turkmenistan (where state control of the financial sector and of foreign investment increased), and Tajikistan (which has had its IMF program suspended due to noncompliance of some key performance criteria). However, some reforms have also sputtered among the Northern Tier CEE leaders, particularly in Hungary, Poland, and the Czech Republic, where the commitment to privatization has at times waned, concerns about the fiscal transparency and independence of central banks have surfaced, and even efforts to re-nationalize enterprises have taken place.

³ This summary is drawn from qualitative assessments from the EBRD's *Transition Report Update* (May 2002), and more recent country reports and regional assessments from the IMF, the World Bank, and the Economist Intelligence Unit.

Of the three sub-regions, the greatest gains since mid-2001 have been made in the Southern Tier CEE. This represents a continuation of a medium term trend (discussed further below). Of all the transition countries, the strongest, broadest-based gains since mid 2001 are most evident in three Southern Tier CEE countries, Yugoslavia, Bulgaria, and Croatia, as well as in Lithuania and Russia.

The qualitative evidence suggests that some of the greatest gains in economic reforms in 2001-2002 have occurred in the second stage reforms in the financial sector, infrastructure reforms, and enterprise restructuring. Less progress and/or more backsliding has occurred in privatization, and first stage reforms of stabilization and liberalization; this is partly due to the global economy slowdown.

Medium term trends in economic reforms. *Table 3 and Figure 1* show 1998-2001 trends in economic reforms, for eight indicators drawn from the EBRD.⁴ Of the three sub-regions, economic reform progress since 1998 has been greatest in the Southern Tier CEE, with Bulgaria and Yugoslavia making the most significant gains within the sub-region. Economic reform progress in the Southern Tier CEE has been broad-based, across most of the first and second stage reforms, though most notably in trade and foreign exchange liberalization.

More modest economic reform progress has been made during this period in the Northern Tier CEE countries. The Southern Tier CEE countries, in other words, have been catching up to the transition leaders of the Northern Tier in this domain. The eight Northern Tier CEE countries, in turn, continue to "cluster" among themselves; as Lithuania, Latvia, and Slovakia move towards catching the leaders, the Czech Republic, Slovenia, and Hungary.

Within Eurasia, in contrast, economic reform progress has proved to be more highly variable and volatile over the medium term, with some backsliding on balance in a handful of countries (particularly Russia, Turkmenistan, and Uzbekistan) and notable gains in a couple others (Tajikistan and Azerbaijan). The data show that the greatest economic reform backsliding since 1997 has occurred in Russia. However, this masks an impressive rebound in reform gains in Russia beginning in 2001 which followed significant reform deterioration in the months surrounding the August 1998 financial crisis.

Overall, the greatest gains in economic policy reforms since at least the mid-90s have occurred among some of the "middle-tier" or moderate reformers. Key characteristics of this group include sufficient political will, significant "room" for further reform progress, and a strong pull towards memberships into Western institutions, the EU most prominently.

⁴ Excluded in *Table 3* and *Figure 1* are three indicators used in *Tables 1* and *2* since: (1) data are not available for infrastructure reform in earlier years; and (2) results on the extensiveness and effectiveness of legal reforms (which are derived from surveys, in contrast to all the other EBRD indicators) are highly variable over the medium term, which in turn skew the averages.

Economic reform gap. *Figure 2* shows trends in the economic reform gap between the Northern Tier CEE countries and Eurasia in 1992, 1996, and 2001. From 1992-2001, progress in economic reforms in the Northern Tier outstripped that in Eurasia in seven of the eight indicators tracked, all but price liberalization. The Eurasian countries appeared to be catching the Northern Tier CEE countries in first stage economic reform gains through the mid-1990s, though this has since been largely reversed. In contrast, the economic reform gap between the reform leaders and laggards in second stage reforms has been steadily increasing since 1992. Of both first and second stage measures, the gap is greatest in trade and foreign exchange reforms, followed by small-scale privatization and banking reform.

Private sector share of the economy. The private sector share of GDP (*Table 4* and *Figure 3*) is a rough proxy of the extent of economic restructuring and progress in economic reforms. An economy's private sector share rises as production is transferred from the public sector to the private sector, and as new private sector firms are nurtured in a business friendly environment.

Private sector shares have increased impressively throughout most of the transition region since communism's collapse. In 1990, roughly 12% of the transition countries' economic output was in private sector hands; today it is closer to 60%. Most OECD economies have private sectors that range from 70-85% of GDP.

The data show a good fit between progress in economic reforms and the size of the private sector. The largest private sector shares are found primarily in the reform leaders; most notably, in Hungary, the Czech Republic, and Slovakia, all with 80% of GDP in the private sector. Moreover, all of the six transition countries with private sector shares less than 50% of GDP cluster at the bottom of economic reform ranking (aggregated in *Table 9* below). Smallest private sectors are found in Belarus (20% of GDP; 26th of 27 countries in economic reform progress), and Turkmenistan (25% of GDP; 27th in reform progress). The most significant "outlier" in this relationship is Albania, which has 75% of its economy in the private sector, and yet ranks well down in economic reform progress (18th).

Table 1. First Stage of Economic Policy Reforms

	Small Scale Privatization	Trade and Foreign Exchange	Price Liberalization	Legal Reforms (Extensiveness)	1st Stage Average
Hungary	5.0	5.0	3.3	3.7 ↓	4.2 ↓
Poland	5.0	5.0	3.3	3.7	4.2
Slovenia	5.0	5.0	3.3	3.7 ↓	4.2 ↓
Croatia	5.0	5.0	3.0	3.7 ↓	4.2 ↓
Latvia	5.0	5.0	3.0	3.7 ↓	4.2 ↓
Lithuania	5.0	5.0 ↑	3.0	3.7 ↓	4.2 ↑
Estonia	5.0	5.0	3.0	3.3 ↓	4.1 ↓
Slovakia	5.0	5.0	3.0	3.3 ↑	4.1 ↑
Czech Republic	5.0	5.0	3.0	3.0	4.0
Bulgaria	3.7	5.0	3.0	4.0	3.9
Georgia	4.0	5.0	3.3	3.0	3.8
Romania	3.7	4.0	3.3 ↑	4.0 ↑	3.8 ↑
Moldova	3.3	5.0 ↑	3.3	3.3 ↑	3.7 ↑
Kyrgyzstan	4.0	4.0	3.0	...	3.7
FYR Macedonia	4.0	4.0	3.0	3.3	3.6
Albania	4.0	5.0	3.0	2.3 ↓	3.6 ↓
Kazakhstan	4.0	3.3	3.0	4.0	3.6
Armenia	3.7 ↑	4.0	3.0	2.7 ↓	3.3 ↓
Russia	4.0	2.7 ↑	3.0	3.0 ↓	3.2
Ukraine	3.3	3.0	3.0	3.3	3.2
Azerbaijan	3.3	3.3	3.0	3.0	3.2
Yugoslavia	3.0	3.0 ↑	3.0 ↑	3.3	3.1 ↑
Tajikistan	3.7 ↑	3.3	3.0	2.0	3.0 ↑
Bosnia-Herzegovina	2.7 ↑	3.0	3.0	1.7 ↓	2.6 ↓
Uzbekistan	3.0	1.7 ↑	2.0	3.0	2.4 ↑
Belarus	2.0	2.0 ↑	2.0 ↑	3.0 ↑	2.3 ↑
Turkmenistan	2.0	1.0	2.0	2.0	1.8
CEE & Eurasia	3.9	4.0 ↑	3.0 ↑	3.2 ↓	3.5
Northern Tier CEE	5.0	5.0	3.1	3.5 ↓	4.2
Southern Tier CEE	3.7	4.1	3.0 ↑	3.2 ↑	3.5 ↑
Eurasia	3.4 ↑	3.2 ↑	2.8	2.9 ↓	3.1
Industrial Countries	5.0	5.0	5.0	5.0	5.0
Benchmarks	4.0	4.0	3.0	4.0	3.8

Note: On a 1 to 5 scale, with 5 being most advanced. A "↑" indicates an advancement from September 2000 to September 2001.

EBRD, *Transition Report 2001* (November 2001).

Table 2. Second Stage of Economic Policy Reforms

	Large Scale Privatization	Enterprise Restruct.	Competition Policy	Banking Sector	Capital Markets	Legal Reform (effectiveness)	Infra-structure	2nd Stage Average
Hungary	4.0	3.3	3.0	4.0	3.7	3.7	3.7	3.6
Estonia	4.0	3.3 ↑	2.7	3.7	3.0	4.0 ↑	3.7 ↓	3.5 ↑
Poland	3.3	3.3 ↑	3.0	3.3	3.7	3.0 ↓	3.7	3.3 ↓
Czech Republic	4.0	3.3	3.0	3.7 ↑	3.0	3.0 ↓	2.9	3.3
Slovenia	3.0	2.7	2.7	3.3	2.7	4.0 ↑	3.3 ↑	3.1 ↑
Lithuania	3.3 ↑	2.7	3.0 ↑	3.0	3.0	3.7 ↑	2.9	3.1 ↑
Slovakia	4.0	3.0	3.0	3.3 ↑	2.3	3.3 ↑	2.5 ↑	3.1 ↑
Latvia	3.0	2.7	2.3	3.3 ↑	2.3	4.0 ↑	3.0 ↑	3.0 ↑
Bulgaria	3.7	2.3	2.3	3.0	2.0	3.7 ↑	2.9	2.8 ↑
Croatia	3.0	2.7	2.3	3.3	2.3	3.7 ↑	2.9 ↑	2.9 ↑
Romania	3.3 ↑	2.0	2.3	2.7	2.0	4.0 ↑	3.2	2.8 ↑
Kazakhstan	3.0	2.0	2.0	2.7 ↑	2.3	4.0 ↑	2.3 ↑	2.6 ↑
FYR Macedonia	3.0	2.3	2.0	3.0	1.7	3.7 ↑	2.1 ↑	2.5 ↑
Russia	3.3	2.3 ↑	2.3	1.7	1.7	3.7 ↑	2.3	2.5 ↑
Moldova	3.0	2.0	2.0	2.3	2.0	3.7 ↑	2.3	2.5 ↑
Georgia	3.3	2.0	2.0	2.3	1.7	3.0 ↑	2.5 ↓	2.4 ↑
Ukraine	3.0 ↑	2.0	2.3	2.0	2.0	3.0 ↑	2.1	2.4 ↑
Armenia	3.0	2.0	2.0 ↑	2.3	2.0	2.0	2.4	2.2 ↑
Kyrgyzstan	3.0	2.0	2.0	2.3	2.0	...	1.5 ↓	2.1 ↓
Uzbekistan	2.7	1.7	2.0	1.7	2.0	3.0 ↑	1.8 ↑	2.1 ↑
Albania	2.3 ↑	2.0	1.7	2.3	1.7	2.0 ↑	2.1 ↓	2.0 ↑
Azerbaijan	2.0 ↑	2.0	2.0	2.3 ↑	1.7	2.0	1.7 ↓	2.0 ↑
Bosnia-Herzegovina	2.3 ↑	1.7	1.0	2.3	1.0	2.0 ↑	2.1	1.8 ↑
Belarus	1.0	1.0	2.0	1.0	2.0	3.0 ↑	1.4	1.6 ↑
Tajikistan	2.3	1.7	1.7	1.0	1.0	2.0 ↑	1.3 ↑	1.6 ↑
Yugoslavia	1.0	1.0	1.0	1.0	1.0	3.0	2.0 ↑	1.4 ↑
Turkmenistan	1.0 ↓	1.0	1.0	1.0	1.0	3.0	1.1	1.3 ↓
CEE & Eurasia	2.9 ↑	2.2 ↑	2.2	2.5 ↑	2.1	3.2 ↑	2.4 ↑	2.5 ↑
Northern Tier CEE	3.6 ↑	3.0 ↑	2.8	3.5	3.0	3.6 ↓	3.2	3.2
Southern Tier CEE	2.7 ↑	2.0	1.8	2.5	1.7	3.1 ↑	2.5	2.3 ↑
Eurasia	2.6	1.8	1.9	1.9 ↑	1.8	2.9 ↑	1.9	2.1 ↑
Industrial Countries	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
Benchmarks	4.0	3.0	4.0	3.0	4.0	4.0	3.0	3.6

Note: On a 1 to 5 scale, with 5 being most advanced. A "↑" indicates an advancement from September 2000 to September 2001.

EBRD, *Transition Report 2001* (November 2001).

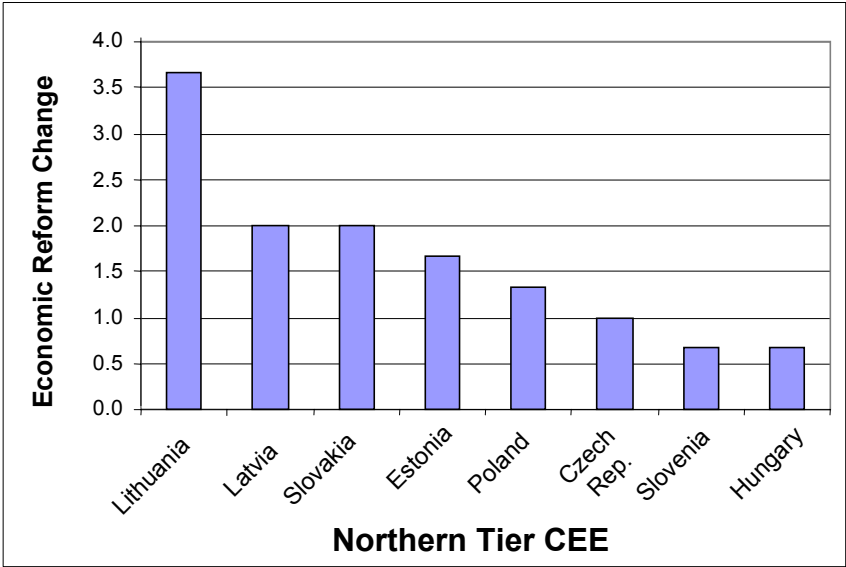
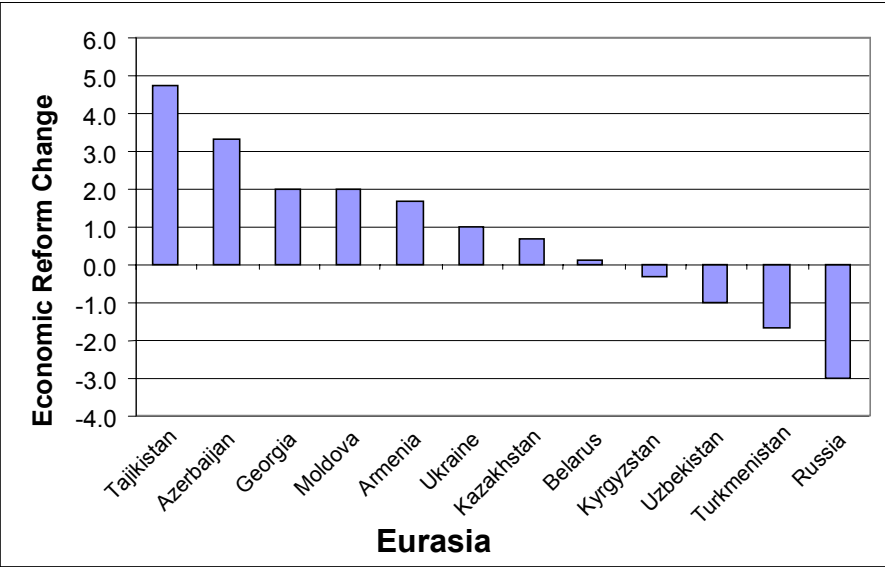
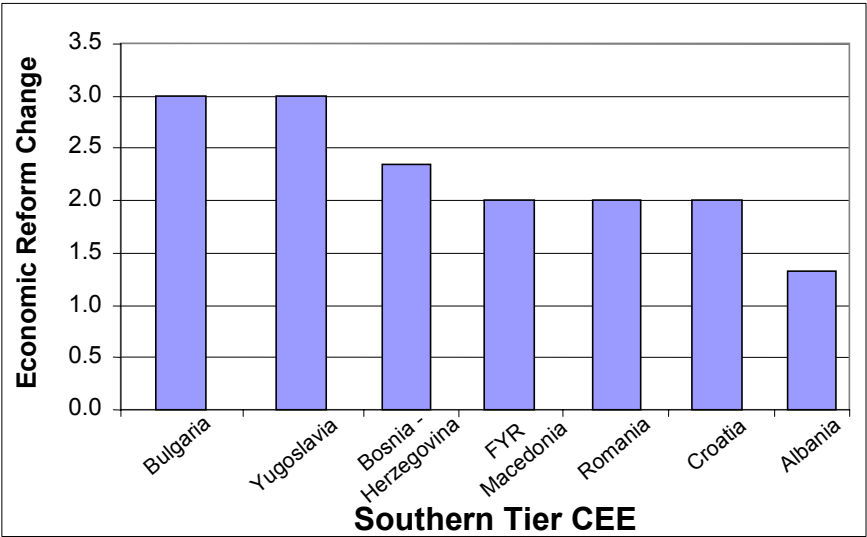
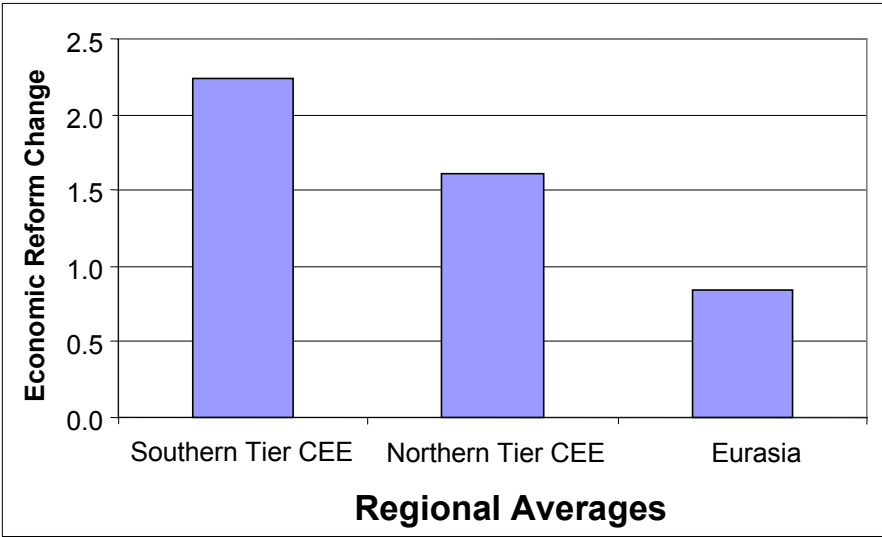
Table 3. Change in Economic Policy Reforms: 1998-2001

	1st Stage			2nd Stage					Total Change
	SSP	PL	TFE	LSP	ER	CP	BR	CM	
Tajikistan	1.4	0.3	1.3	0.3	0.7	0.7	0.0	0.0	4.7
Lithuania	1.0	0.0	1.0	0.3	0.0	0.7	0.0	0.7	3.7
Azerbaijan	0.3	0.0	1.0	0.0	0.0	1.0	0.3	0.7	3.3
Bulgaria	0.7	0.0	1.0	0.7	0.0	0.3	0.3	0.0	3.0
Yugoslavia	0.0	1.0	2.0	0.0	0.0	0.0	0.0	0.0	3.0
Bosnia-Herzegovina	0.7	0.0	1.0	0.3	0.0	0.0	0.3	0.0	2.3
FYR Macedonia	0.0	0.0	0.0	0.0	0.3	1.0	0.0	0.7	2.0
Romania	0.7	0.3	0.0	0.7	0.0	0.3	0.0	0.0	2.0
Latvia	1.0	0.0	1.0	0.0	0.0	-0.3	0.3	0.0	2.0
Slovakia	0.0	0.0	1.0	0.0	0.3	0.0	0.7	0.0	2.0
Croatia	0.0	0.0	1.0	0.0	0.0	0.3	0.7	0.0	2.0
Georgia	0.0	0.3	1.0	0.0	0.0	0.0	0.0	0.7	2.0
Moldova	0.3	0.3	1.0	0.0	0.0	0.0	0.3	0.0	2.0
Estonia	0.0	0.0	1.0	0.0	0.3	0.0	0.3	0.0	1.7
Armenia	0.7	0.0	0.0	0.0	0.0	0.0	0.0	1.0	1.7
Albania	0.0	0.0	1.0	0.3	0.0	-0.3	0.3	0.0	1.3
Poland	0.0	0.3	0.0	0.0	0.3	0.0	0.3	0.3	1.3
Czech Republic	0.0	0.0	0.0	0.0	0.3	0.0	0.7	0.0	1.0
Ukraine	0.0	0.0	0.0	0.7	0.0	0.3	0.0	0.0	1.0
Slovenia	0.0	0.3	0.0	-0.3	0.0	0.7	0.3	-0.3	0.7
Hungary	0.0	0.0	0.0	0.0	0.3	0.0	0.0	0.3	0.7
Kazakhstan	0.7	0.0	-0.7	0.0	0.0	0.0	0.3	0.3	0.7
Belarus	0.0	-1.0	1.0	0.0	0.0	0.0	0.0	0.0	0.0
Kyrgyzstan	0.0	0.0	0.0	0.0	0.0	0.0	-0.3	0.0	-0.3
Uzbekistan	0.0	-0.7	0.0	0.0	-0.3	0.0	0.0	0.0	-1.0
Turkmenistan	0.0	0.0	0.0	-1.0	-0.7	0.0	0.0	0.0	-1.7
Russia	0.0	0.0	-1.3	0.0	0.3	0.0	-0.7	-1.3	-3.0
Average Change									
CEE & Eurasia	0.27	0.05	0.49	0.07	0.07	0.17	0.16	0.11	1.41
Northern Tier CEE	0.25	0.08	0.50	0.00	0.21	0.13	0.33	0.13	1.62
Southern Tier CEE	0.29	0.19	0.86	0.28	0.05	0.24	0.24	0.10	2.24
Eurasia	0.28	-0.06	0.28	0.00	0.00	0.17	0.00	0.11	0.78
Benchmark	0 or greater								

Note: The sub-headings refer to the following economic reforms: (SSP) small-scale privatization; (PL) price liberalization; (TFE) trade and foreign exchange reforms; (LSP) large-scale privatization; (ER) enterprise restructuring; (CP) competition policy; (BR) bank reforms; and (CM) capital market reforms. The change is based on a rating from 1 to 5, e.g., Tajikistan advanced "1.3" in TFE reforms, from a "2" to a "3.3" from 1998 to 2001. Environment policy, legal reforms and infrastructure reform are excluded.

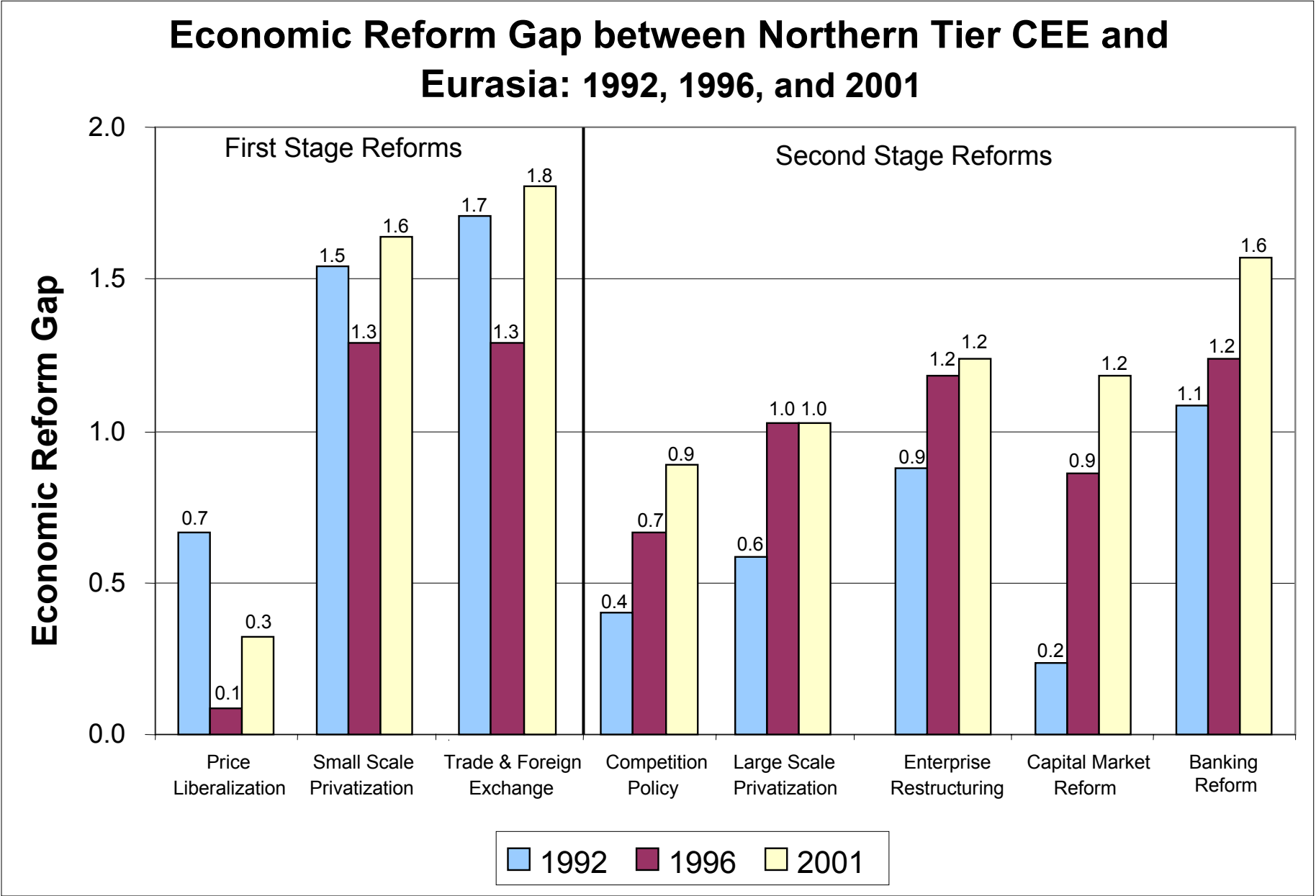
Figure 1

Progress and Backsliding in Economic Reforms, 1998 - 2001



EBRD Transition Report 2001 (November 2001) and previous editions.

Figure 2



Economic Reform gap is the Northern Tier CEE economic reform score minus the Eurasia score.
Tables 1 and 2, drawing from EBRD, *Transition Report 2001* (November 2001).

Table 4. Private Sector Share of GDP

Country	1990	1994	1996	1998	2001
Hungary	25	55	70	80	80
Czech Republic	10	65	75	75	80
Slovakia	10	55	70	75	80
Albania	5	50	75	75	75
Estonia	10	55	70	70	75
Poland	30	55	60	65	75
Russia	5	50	60	70	70
Lithuania	10	50	70	70	70
Bulgaria	10	40	55	65	70
Latvia	10	55	60	60	65
Romania	15	35	60	60	65
Slovenia	15	30	45	55	65
Kyrgyzstan	5	30	50	60	60
Armenia	10	40	50	60	60
Georgia	15	20	50	60	60
Kazakhstan	5	20	40	55	60
Ukraine	10	30	50	55	60
Croatia	15	40	50	55	60
FYR Macedonia	15	35	50	55	60
Azerbaijan	10	20	25	45	60
Moldova	10	20	40	45	50
Uzbekistan	10	20	40	45	45
Tajikistan	10	15	20	30	45
Bosnia-Herzegovina	15	(20)	(25)	(30)	40
Yugoslavia	15	(20)	(25)	(30)	40
Turkmenistan	10	15	20	25	25
Belarus	5	15	15	20	20
REGIONAL AVERAGES (unweighted)					
	1990	1994	1996	1998	2001
CEE & Eurasia	12	35	49	55	60
Northern Tier CEE	15	53	65	69	74
Southern Tier CEE	13	34	49	53	59
Eurasia	9	25	38	48	51
OECD	70-85				
Benchmark	More than 70%				

EBRD, *Transition Report 2001* and *Transition Report 1999* (November 1999).
Numbers in parentheses are estimates based largely on interpolation.

Figure 3

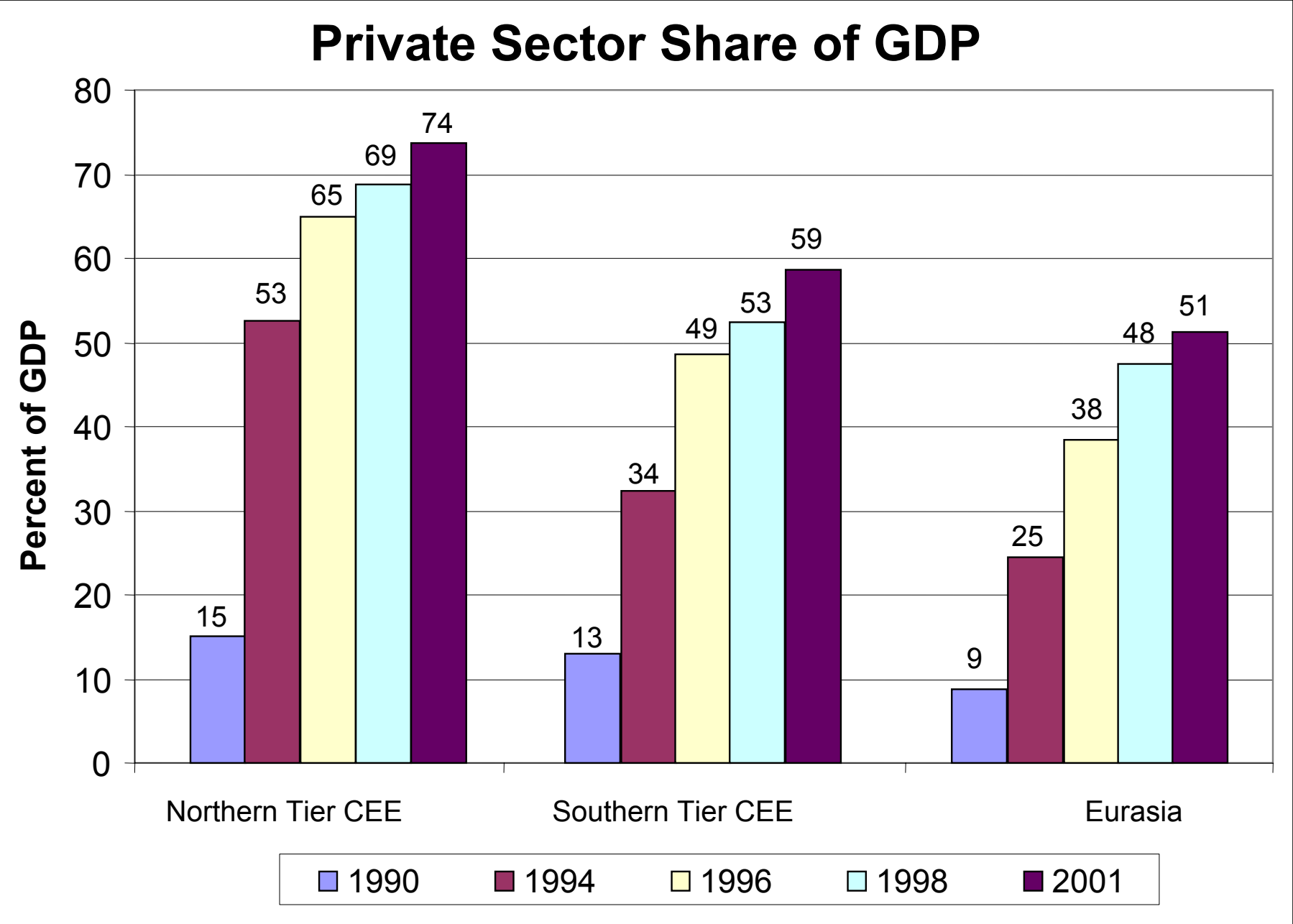


Table 4, drawing from EBRD, *Transition Report 2001* (November 2001) and *Transition Report 1999* (November 1999).